

**Emerging Internet Telephony:  
States might want to Fight for their Tax Bases,  
but we're Better Off if they Don't**

Comment to the FCC in support of the Vonage petition  
WC Docket No. 03-211  
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Technological change in conjunction with the Internet has increased the number of close substitutes for a variety of products, including telephone-type services. One economic effect is an increased elasticity of demand facing individual producers of goods and services, which in turn lowers market power.<sup>2</sup> The emergence of close substitutes for traditional telephone services has reduced market power and changed the market structure of the industry away from monopoly and toward competition.

Taxes, government mandates, and regulations each increase the price paid by consumers, and therefore can be considered together as either implicit or explicit taxes. The emergence of close substitutes that reduce market power therefore threatens the tax base. Just as the increased competition lowers the elasticity of demand and reduces the price-setting abilities of individual companies, so too this technology-induced competition reduces the ability of state public utility commissions to tax traditional telephone services.

**To protect their revenue and regulatory abilities, states might wish to erect barriers to entry that would counter the effects of technological change and maintain market power.** For example, requiring Vonage to bundle its VoIP services with emergency 911 services would accomplish this end, since the technology to allow the geographical identifiers needed for e911 either does not exist or is not readily available.

The “duck test” applied by the Minnesota Public Utility Commission and referred to extensively since is unconvincing. Consider the rubber duck. While a rubber duck might look like a duck and quack like a duck, it nonetheless would not have the internal organs of a duck and could not lay duck eggs. Nor could it grow duck down. Yet, many consumers would prefer the rubber duck to the real duck. Likewise, consumers might buy the bundle of services offered by Vonage, Packet8, et. al., as a replacement for or in addition to the somewhat different bundles possible under plain old telephone service (POTS). To the extent that the choice is voluntary and consumers know what they are doing, their choices make them better off.

States actions can raise other barriers to entry, including not only the obvious costs of the regulatory

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<sup>2</sup>Market power is sometimes called monopoly market power, because it is greatest under monopoly. Plain old telephone service (POTS) used to have characteristics of monopoly, but technological change has increased competition and thereby altered its market structure.

process, but also uncertainties as to future regulatory penalties. Taken one at a time, state actions are unlikely to have much effect on technological change or choices available to their citizens over time. **States have an incentive to free ride when it comes to technological change** – they might aggressively protect their tax bases on the presumption but their doing so would have a negligible effect on the pace of overall technological change. **However, the individual interests of the states in this regard seem likely to conflict with the collective interests of society, which is generally enhanced by choice, competition, and technological progress.** States might even prefer that federal guidelines constrain their actions, just as the United States is voluntarily bound by the rules of the GATT.

In a federal system of government, it is the role of the federal government to set parameters, looking to maximize economic welfare for the country as a whole. In this case, the Federal Communications Commission has the opportunity to set those parameters. **A reasonable choice is for the FCC to establish a moratorium on state regulation of Internet voice and data services. The benefit from this course of action is increased competition in the present and increased innovation over time.**

While shrinking the tax base available to states might seem like a cost to be prevented, it is not a cost from the point of view of the country. Rather, it is beneficial because it comes about through increased choices available to consumers. For states to generate monopoly market power through regulatory action, in contrast, would not promote the economic welfare of the country as a whole.

This comment is submitted in support of the Vonage petition.